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DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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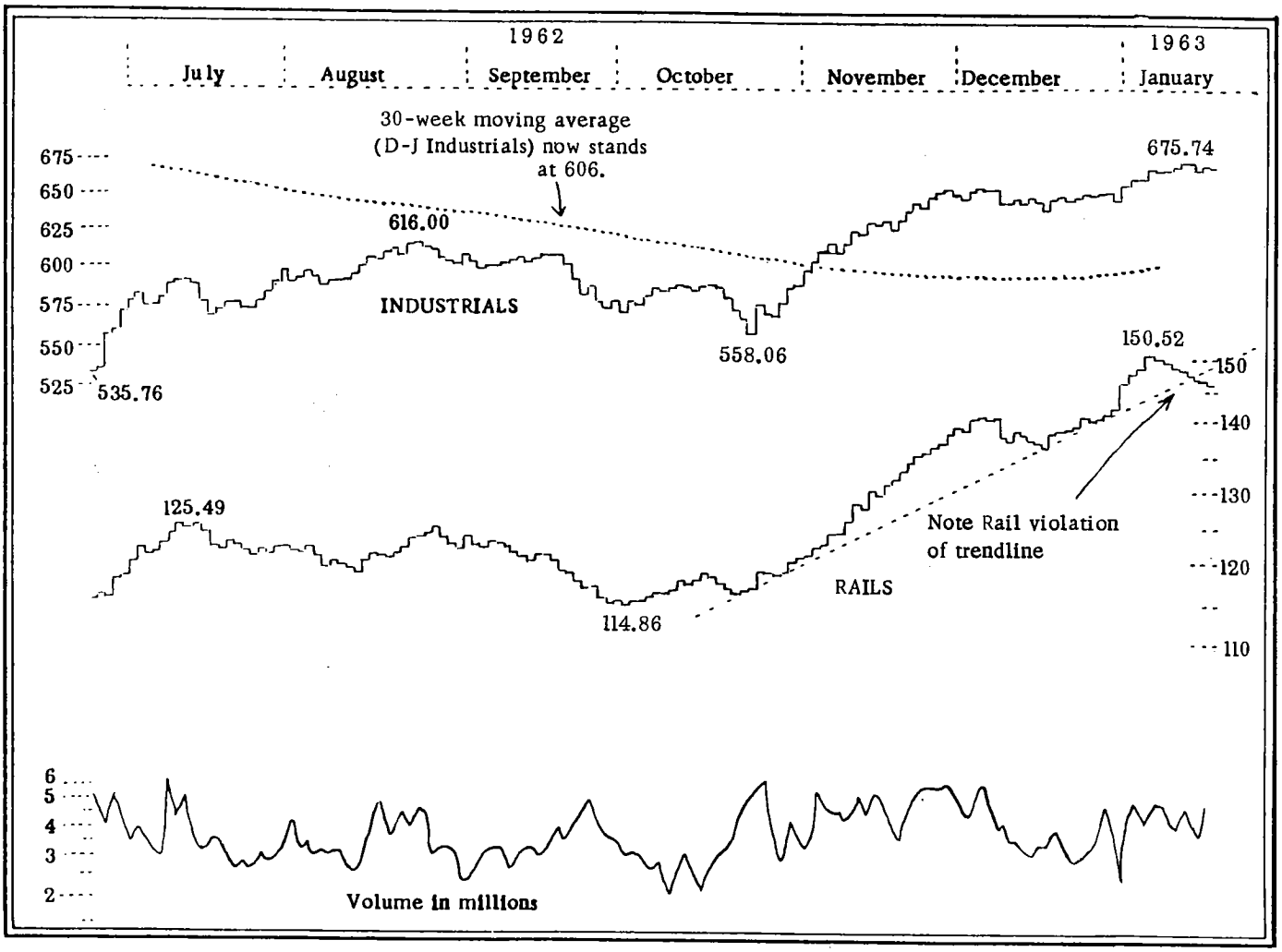
An unusual amount of correspondence has been coming to this office over the past month. Informed observers have presented their arguments for (1) a new bull market, (2) a continuing bear market correction, (3) a resumption of the bull market of the 1950's.

"Has anyone suggested," writes a student from Yakima, Washington, "that what the market foresaw when it crashed was the missile buildup in Cuba, and that it was not an economic bust that it was forecasting?"

A veteran trader from Newtown Square, Penna., writes: "I am still of the opinion that the slump of mid-1962 is not a thing to be forgotten. In fact, I find it appalling that sentiment has changed so drastically since last summer. Perhaps we shall have to live out a period of backing and filling, but my feeling is that the major decline should soon (immediately or by March) be resumed."

A broker from New York states: "It is just a matter of time before Rails better their 1961 high of 152.92 and Industrials go through their 1962 high. You can't have a bear market with all this money around."

The majority of opinions now being expressed are strongly bullish; nevertheless, this writer continues to be bothered by many factors connected with the 1962-63 rise. Recent Letters have discussed the confusing patterns which have materialized in



individual stocks, the sluggish Low-Priced Stock Index, Barron's lagging Business Index, the strong bond averages, and the breaking of long-term trendlines by both D-J Averages in 1962. In addition, the current Letter examines the extraordinary volume which has recently appeared in the D-J Rail stocks and the dawdling patterns of leading foreign stock averages.

* * * * *

Letter 206 listed facts on eleven violent market rallies. In only one case (1932) was one of these "buying panics" followed by an extended bull market rise.

The most recent buying panic (not listed in Letter 206) occurred during 1960-61 (following the long 1959-60 decline). I believe that it will be instructive to review that period.

On March 22, 1961, Rails reached a high of 150.81. A four-day decline ensued. Against a declining (diverging) Rail Average, Industrials then rose to a new high on May 17. The new high was not confirmed by Rails, and in the face of this non-confirmation, Industrials and the A-D ratio turned sharply down.

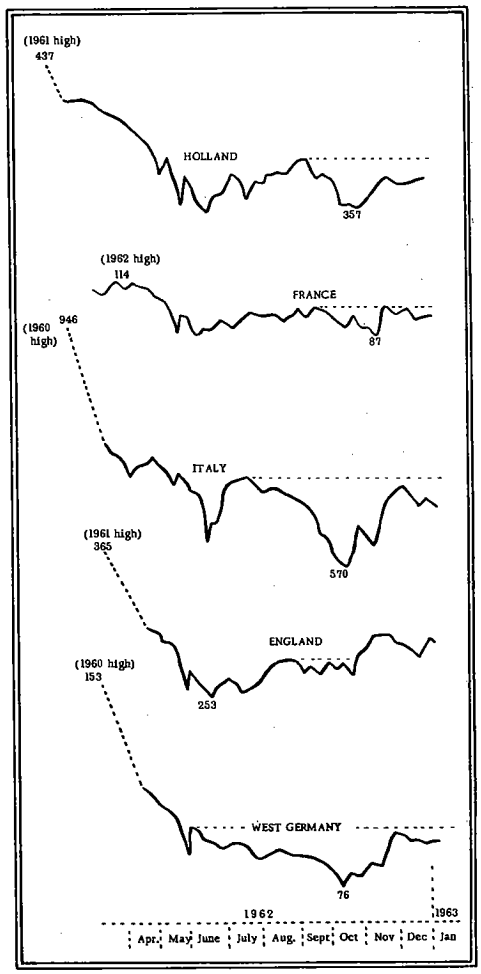
May 17 proved to have been the peak for the A-D ratio. Following the "topping out" of that indicator, the market entered into a long series of confusing non-confirmations and divergences, a series which lasted until the end of 1961. During that time the Industrial Average was locked in a trading range bordered by 734 on the upside and 680 on the downside. Within the trading range it was characteristic for first one Average, then the other, to push to a new high or low -- but never to new highs or lows together. Individual stocks (as many subscribers will remember) would "break out" of patterns on heavy volume, then fall back in a manner which did nothing but frustrate the buyers. In retrospect, we now know that the 1961 trading range was a major area of distribution. In January, 1962, the great decline began.

Referring to the current market, the explosive or buying-panic phase began on October 24, 1962. Toward late December a series of minor "out-of-gear" movements occurred (Industrials and the A-D ratio would not follow the rising Rails), but this potential trouble was resolved satisfactorily when all three indicators finally rose to joint recovery highs on January 4, 1963.

Such action (particularly following a "line" in the Averages) should ordinarily send the market higher for at least four or five additional weeks. In view of the "all clear" signal of January 4, it was therefore rather surprising to see Rails record a peak (150.52) on January 8 -- just two trading days later.

Subsequent to the January 8 Rail peak, the carriers declined steadily. Industrials, however, rose to a new (but unconfirmed) recovery high (675.74) on January 14. A sell-off occurred on January 16, followed by a further Industrial rally (against a still declining Rail Average).

CONCLUSION: Another "all clear" signal will be given if Rails can better their January 8 peak of 150.52. Conversely, a persistent refusal by carriers to confirm (better 150.52) would suggest a nearby consolidation or a reversal of trend.



FOREIGN MARKETS I have often stated that all primary movements and most important secondary movements are international in scope. From time to time "profiles" of the major foreign stock averages have been included in these Letters, and readers should now have had ample opportunity to test the truth of the opening statement.

The rationale for the "international stock movement" thesis is simple enough. Factors which affect the economy of one country are very apt to affect the economies of other nations in a free world economy. For instance, if the price of copper rises here, copper prices will firm throughout the world. If the English and Dutch banks lower their discount rate, such action will take pressure off money rates in this country.

Because the major markets of the world tend to move together, I have felt that important conclusions might be drawn when the majority of the world's markets were "saying the same thing." Thus, during 1961 I drew repeated attention to the poor position of the leading foreign markets.

As seen on the accompanying chart, Italy's average "topped out" in 1960 (followed by a severe collapse). West Germany's market also hit its high in 1960, Holland and England struck peaks in 1961. The U.S. and France were the only major markets to record highs in 1962.

England recorded its low in June, 1962 (along with the D-J Industrial Average), but the rest of the world markets touched lows in October. Since the 1962 lows, only two stock averages (U.S. and England) have bettered preceding secondary highs.

CONCLUSION: Despite the many published comments and articles regarding the strength of the European economies, none of the European stock averages have staged recoveries comparable to the recovery in the D-J Industrial Average, and only one other market (England) has bettered its preceding secondary peak. The majority of foreign exchanges have therefore not confirmed the strength of the U.S. market.

THE RAILS Back in Letter 150 and again in Letter 167 I presented studies of the D-J Rail Average together with volume in the D-J Rail stocks (Rail volume figures are provided by both Barron's and the Wall Street Journal).

Normally, volume in the D-J Rails runs about 60 to 70 thousand shares per day. Occasionally, however, we see periods in which Rail volume will expand to double and even triple average daily Rail volume. Such periods must be considered areas of abnormal Rail activity, and the action following such periods has (in the past) been significant.

I have included a chart which appeared in Letter 167. Here we see Rails recording a peak of 150.81 (March, 1961) on extraordinary D-J Rail volume of 293 thousand shares. A decline immediately ensued, followed by a second rally to 149.02. Again Rail volume flared -- and again Rails turned down.

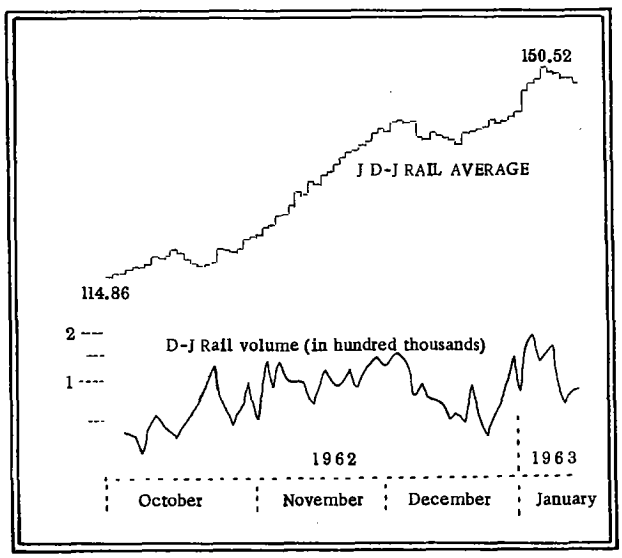
Toward the end of 1961 the Rails staged another rally. On October 6, Rail volume rose to 203 thousand shares, and four days later the carriers recorded a 1961 peak of 152.92. That peak has not since been surpassed. A second assult on the 152.92 high occurred in November, 1961 (see chart), but to the accompaniment of exploding Rail volume, the Rail Average again turned down.

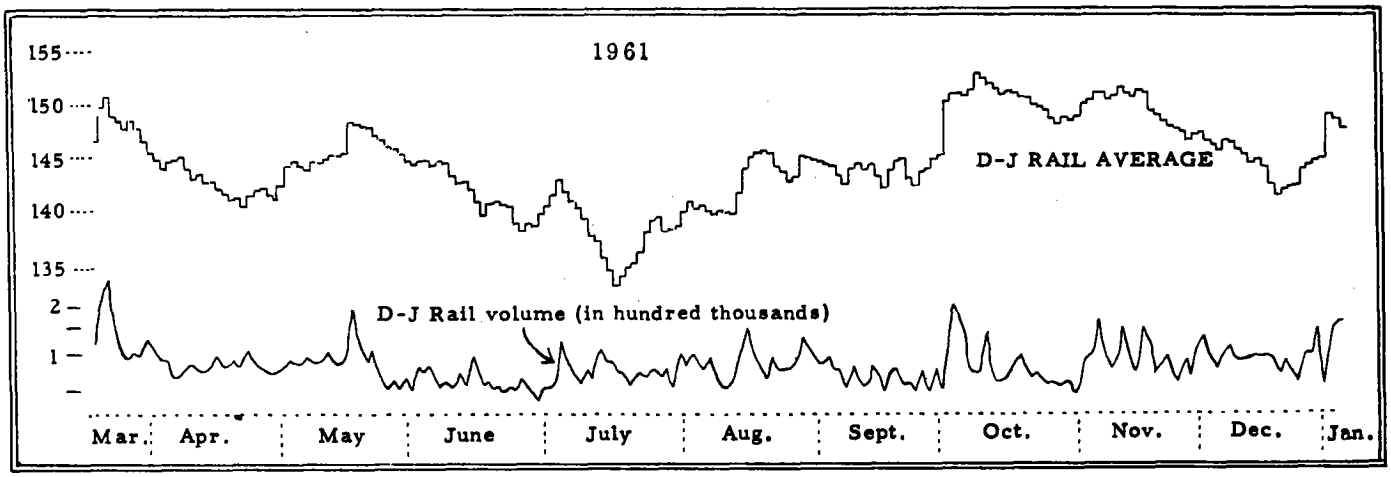
The decline from the 152.92 (1961) high ended for Rails in October, 1962 at 114.86. Looking back, we now know that the areas of extraordinary Rail volume during 1961 were, in reality, areas of distribution.

The recent Rail action (since October, 1962) together with daily D-J Rail volume is shown on the smaller chart. As seen on that chart, the entire area of November, early December, and January, 1963, was marked by heavy Rail volume.

On December 4, Rail volume jumped to a post-crash high of 163 thousand shares. This volume expansion coincided with a minor peak of 140.37 on the Rail Average. A second rally took Rails to their recent recovery high of 150.52 (January 8, 1963). Rail volume on that day was 155 thousand shares. One day later Rail volume leaped to 178 thousand shares, the heaviest Rail volume since October, 1961 (see chart).

For over two years, whenever the Rail Average has entered the 148-152 range, volume has exploded in the carrier Average --





followed by a general Rail decline and either a sideways movement (as per 1961) or a decline (as per 1962) in the general market. It will be interesting to see whether Rails will be able, at this time, to extend their gains above the formidable 152.92 barrier (the 1961 peak), or whether the huge Rail volume of the past few months implies that the carriers have been under important distribution again.

LATE NOTES (written Monday, January 21, 1 P.M., N.Y. time). The market has been backing off listlessly, and today seems to be more of the same. An Industrial breaking of January 16's 669.00 on increasing volume would be the first danger signal. Conversely, a persistent refusal by Industrials to penetrate that level will suggest another try at the 675.74 high. Continued R ail decline or divergence would be a definite "caution signal."

STOCKS Of 350 representative stocks which are tabulated at this office, 270 or 77% are now holding above their 30-week moving average (a drop of 5% from last week). Of the same 350 stocks, 187 or 53% are now above their August, 1962 peak (a rise of 11%).

The manner in which a stock or groups of stocks perform as compared to the general market is known as "relative strength." Relative strength charts are often useful in identifying places to put one's money or the places to remove one's money. It is well to remember that relative strength is a "relative thing." If a relative strength line is rising, that stock may not be "a buy", and, in fact, the stock might go down with the market -- but the rising relative strength line implies that the stock will go down slower than the general market. It will also be one of the best buys at the next turn or on the next market advance.

For example, note the reversal (to the upside) in the auto group relative strength line as early as June, 1961. Auto relative strength improved through the rest of '61 and through 1962. The auto group declined in early '62, but they were among the most sluggish decliners on the downside and the best risers on the upside. Relative strength charts suggested that they would be.

Conversely, note the continuing poor performance of the relative strength line in building stocks. The chart implies that issues like Johns Manville, U.S. Plywood and National Lead will be the best shorts on the next broad decline.

Two groups which show recent reversals to improving relative strength are agricultural equipment and meat packing. In the former group, Case and Wilson are interesting speculations with International Harvestor the investment quality issue. In the latter group Wilson and Cudahy are the speculative issues with Swift the "blue chip."

Relative strength charts on this page courtesy of Traders Research, P. O. Box 2466, St. Louis 16, Missouri.